

BKI Quarterly Report



Highlights of 2016 and New Opportunities in 2017

Welcome to the 13th issue of the BKI Quarterly Report. This Report, and previous issues, is available on our website at <http://bkilimited.com.au/>. As we begin 2017, the Management and Board of BKI would like to wish you and your families a safe and prosperous new year and we thank you for your continued interest.

As the curtain has been drawn on 2016, we reflect on a year that has been the most unusual in recent memory. 2016 was the Chinese Year of the Monkey but many have called it the year of the Underdog.

A year ago, any suggestion that Donald Trump would win the US Presidential election was met with bemusement and disbelief. And no one talked about Brexit, let alone the multiple sporting upsets which included the Chicago Cubs, Leicester City, the Cronulla Sharks, the Western Bulldogs and for the die-hard rugby fans, who could forget the Northern Suburbs premiership victory at North Sydney Oval in August!

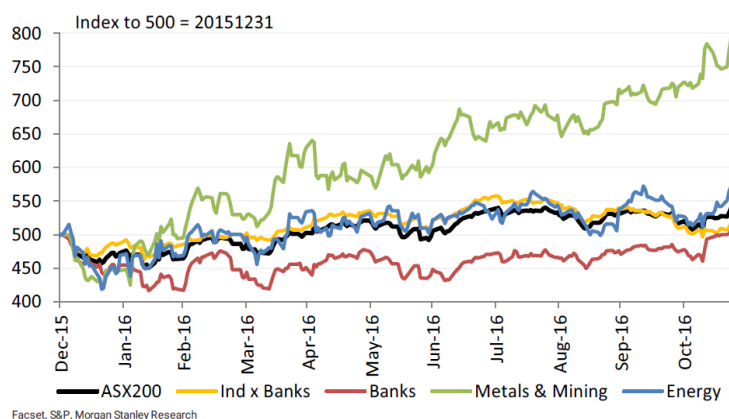
Equity Market Overview

The stock market recorded a year of volatility. This was partly attributable to the events surrounding Brexit and the US election as mentioned above, however the upsets didn't stop there. The little guy, the S&P/ASX Small Companies Accumulation Index, was the first upset - outperforming in the year to 31 December 2016, by returning 13.2%, compared to the S&P/ASX 300 Accumulation Index, up 11.8%.

The other upset was seen in the strength of the Metals and Mining stocks, with the S&P/ASX Resources Index generating a return of 42.4% for the year to 31 December 2016. This performance was aided by a rally in commodity markets on the back of a weak US Dollar, tighter supply and broadly stronger Chinese demand. Iron Ore was the big turnaround, rising 90%, followed by oil up 45% and copper up 17%. Even gold, which topped out at close to \$US 1400/oz before falling to a low of \$US 1135/oz on the back of declining deflation fears, finished the year in positive territory, 9% higher.

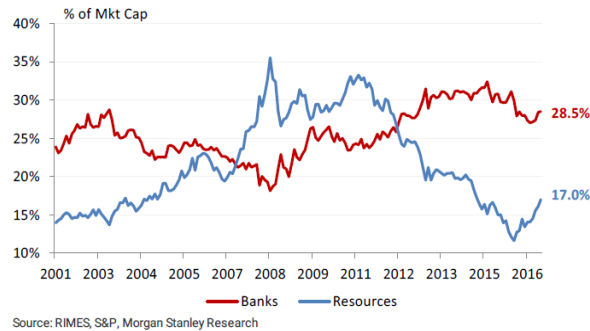
However, the one year numbers hide just how weak the Resources sector stocks were in the previous five years. There is some mean reversion in the performance of the Metals and Mining sector in 2016 as commodity prices finally rallied. This is shown clearly in the chart to the right from Morgan Stanley (Morgan Stanley Research, 2017 Australia Macro+ Outlook, November 29 2016).

Resources Outperformance of S&P/ASX200 Index



Again referring to the Morgan Stanley Research, 2017 Australia Macro+ Outlook as published in November 2016, the Resources sector accounts for 17% of the ASX 200 Market Cap having been as high as +30% in the boom times of 2008 and 2011.

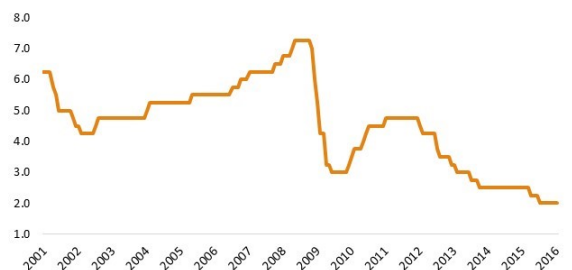
Banks/Resources % of Market Cap of S&P/ASX200 Index



Rates and Currency

Australia's historically low interest rate environment continued with the RBA leaving interest rates on hold in early December at 1.50%. There is still little incentive for investors to transition into cash given the very low rates on offer. We can see this theme continuing throughout 2017, especially if the RBA cuts rates to 1.00% - 1.25%.

RBA Cash Rate – Last 15 Years



Given the buoyant employment conditions in the US, coupled with the significant investment expected in infrastructure, oil and gas sectors, the US Federal Reserve increased rates in December – the first increase for several years.

Expectations are now indicating that the US economy could lift growth from 2.2% in 2017, to 2.5% in 2017 and 2.6% in 2018. Given the inflationary impacts expected from President Trump's policies, consensus expectations (based on 67 economists) are that US rates will continue to increase during 2017 and into 2018. The majority of the forecasters believe rates could rise to 1.25% by the first quarter 2018.

Australian Dollar – Last 5 Years



The Australian dollar has weakened since the US election and the rise in the cost of offshore funding has led banks to raise their mortgage rates independently of the downward trend of the official cash rate. As discussed previously, we expect the Australian dollar will continue to weaken in the coming year as the US economy continues to improve and the US Dollar appreciates. Market consensus on the Australian Dollar is currently at 73USc.

BKI Portfolio has exposure to companies with offshore earnings that should be beneficiaries of a lower Australian Dollar, including:

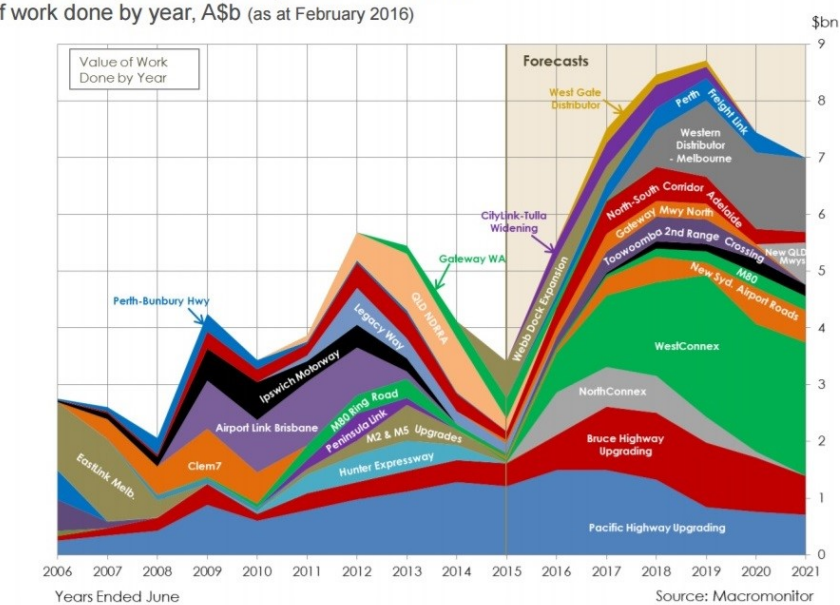


Infrastructure

Australia is undergoing a significant transformation thanks to federal and state government spend on major infrastructure projects. As can be seen in the charts below from Macromonitor, construction projects across Australia are significant and are likely to run for many years to come.

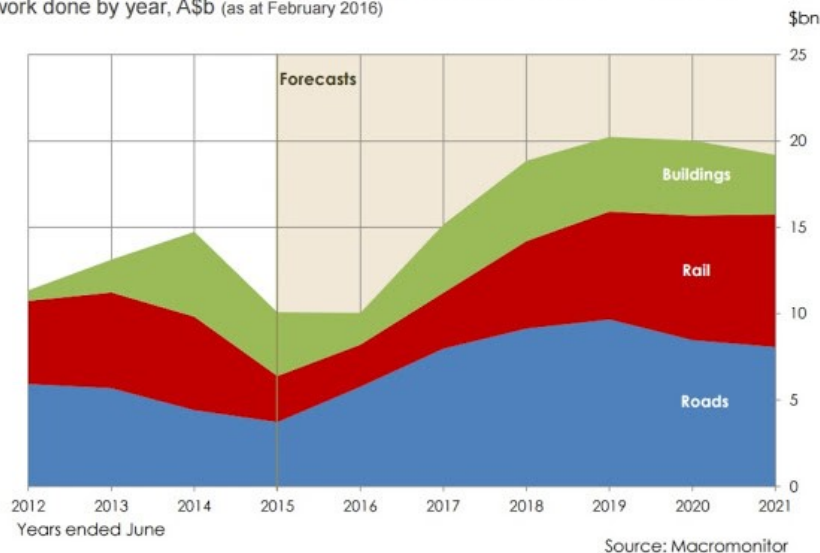
Major Road Construction Projects – Australia

Value of work done by year, A\$b (as at February 2016)



All Major Construction Projects (excluding resource sector) – Australia

Value of work done by year, A\$b (as at February 2016)



One of the beneficiaries of this spend is captured through long term passive infrastructure investments in industries including - 1) Transport - Road, Rail, Airports, 2) Freight and Logistics, 3) Gas Networks and 4) Telecommunication Networks. The BKI Portfolio is well positioned here with exposure to the following companies:



Contact Asset Management

As we discussed in November, the vision of Contact is to act as an external manager of Listed Investment Companies across various asset classes. BKI is Contact's initial client, however, Contact is hoping to introduce another investment opportunity to shareholders in the coming months.

We take great pride and responsibility in investing shareholders' capital, and thus will take a long-term, conservative investment approach that is consistent with the proven philosophy of BKI Investment Company and WHSP. Also having spent considerable time within the listed investment space, Contact's competitive fee structure will be a point of differentiation. We hope to be able to provide an update on this opportunity in the coming weeks.



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